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Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 11-19, 32

IN THE MATTER

of

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY.

BRIEF FOR *AMICUS CURIAE*

JOHN L. HALL

JAMES GARFIELD,
CHARLES P. CURTIS, JR.,
Of Counsel.

September 30, 1942.

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CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY.

Motion for Leave to File Brief as *Amicus Curiae*

To The Honorable The Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The undersigned, a member of the bar of this Court, respectfully prays leave to file the attached brief as *amicus curiae* on behalf of the railroads named herein. There have been filed with the Clerk of this Court the written consents of all parties who have entered appearances here in these cases, and the condition regarding service which was attached to some of those consents has been performed.

Respectfully submitted,

JOHN L. HALL,
30 State Street,
Boston, Massachusetts.

September 30, 1942.

Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 11-19, 32

IN THE MATTER

of

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY.

BRIEF FOR *AMICUS CURIAE*

Statement

This brief deals with the meaning and interpretation of Section 77 of the Bankruptcy Act relating to the reorganization of railroads engaged in interstate commerce. It is filed on behalf of:

Chicago, Rock Island and Pacific Railway Company

Chicago and North Western Railway Company

The Denver and Rio Grande Western Railroad Company

Missouri Pacific Railroad Company

St. Louis Southwestern Railway Company.

It is also concurred in by Chicago, Milwaukee, St. Paul and Pacific Railroad Company, the Debtor herein.

The railroads above named comprise most of the Class I railroads of the United States now in reorganization under Section 77 of the Bankruptcy Act. The present status of their reorganization proceedings is shown in the Appendix, *infra*. In each case the Interstate Commerce Commission has already approved and certified a plan of reorganization drastically reducing existing capitalization and eliminating the equity of the present stockholders. The reports of the Commission are like that in the instant case in failing to state reasons for conclusions. In most of the cases the record before the Commission was closed at least four years ago.

By the terms of Section 77(d) the debtor,* as distinguished from its trustees, creditors or stockholders, is expressly charged with the responsibility of filing a plan of reorganization. Its duty involves not only the preparation of the plan but also the presentation of evidence in support thereof at the hearings before the Commission and the courts at all stages of the proceedings. Experi-

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*It has been suggested that Section 77 makes the Commission the "reorganizer" of railroads (See the brief of the Institutional Bondholders Committee in the *Western Pacific* case, p. 48) in place of the security holders who in an equity receivership were accustomed to work out a plan by a process of bargaining and then present it to the Court and the Commission as an accomplished fact.

While undoubtedly one of Congress' purposes was to prevent the Commission and the Court from being thus more or less compelled to approve the parties' plan, Section 77 does not substitute the Commission for the parties as the originator of a plan. On the contrary, it is the Debtor that is expressly required to prepare a plan [subsection (d)].

The Debtor is the corporation itself and as such includes all of the security holders and stockholders. It is therefore uniquely qualified to initiate and preside over the negotiations leading up to the preparation of a plan representing the combined judgment of all parties, a negotiated plan, not one imposed from without. If any party does not accept the combined plan it may file proposals for modification or a plan of its own. The Commission, unless it finds such plan or plans *prima facie* impracticable, must hold hearings on them and may then approve a plan, which may be the Debtor's plan or some modification of it or some other plan, or which may differ from any of them. Although the Commission is thus given power to pass upon plans proposed by the parties and make such changes as it considers necessary to comply with the requirements of the statute, it is not set up as the originator of the plan. The Debtor, not the Commission, is substituted for the parties as negotiator and initiator.

ence has shown that the debtor is usually the only party to the proceedings with an interest extending beyond the claims of one particular class of creditors or stockholders. The debtor speaks for every class to the extent that it is not, in whole or in part, separately represented. Such separate representation is naturally interested primarily in the rights of a particular class and those rights usually assume greater importance in the minds of the parties than the welfare of "the situation" as a whole or the public interest.*

Thus the debtor is ordinarily the only party free to give adequate consideration to the problem as a whole and to the public interest. It is therefore appropriate that this amicus brief should be filed on behalf of the debtors themselves in the various proceedings now pending under Section 77.

OUTLINE OF ARGUMENT

I. Section 77 must be interpreted in the light of the fact that railroads are subject to government regulation in the public interest.

To understand the full meaning of Section 77 of the Bankruptcy Act it is necessary to consider the peculiar obligations under our laws of a railroad engaged in interstate commerce, and also the purpose of Congress to foster and protect an adequate transportation system. *Dayton-Goose Creek Ry.* v. *United States*, 263 U. S. 456 at 477-8.

A.

Railroads are permitted by law to function because they are performing a public service.

* See for example the comments of the C.C.A. in the instant case upon the attitude of the several groups of bondholders toward the Commission's plan and the treatment proposed therein for themselves and each other (R. 2303; 124 Fed. (2d) 754, 760).

The federal government recognizes and sanctions the existence of railroads on that basis.

Congress has entrusted the regulation of the railroads to the Interstate Commerce Commission under directions contained in the Interstate Commerce Act and other statutes.

Under such statutes the regulatory authority of the Interstate Commerce Commission extends to and permits it to prescribe and limit almost all the activities of a rail carrier. Either the statute itself or the authority exercisable by the Commission thereunder requires the rail carrier to serve all comers; to share the use of its property with other carriers; limits and prescribes the functions which it shall perform and the rates to be charged therefor; regulates acquisitions or extensions of its property and leases, mergers and consolidations; forbids issuance of securities or assumption of obligations without permission of the Interstate Commerce Commission; and prohibits the abandonment of property or service without a finding of the Interstate Commerce Commission that public necessity and convenience will permit such abandonment and may thus compel continuance of maintenance and operation of property even without profit.

All this is done because Congress has recognized that it is in the public interest. The Interstate Commerce Act and other statutes contain numerous references to the public interest or the public convenience and necessity, and numerous requirements that property shall be used or shall not be used in certain ways if the public interest demands, although if public interest were not involved such requirements or prohibitions could not be imposed on private property.

Since 1920, the railroads have been placed by statute under what this Court has described as the "fostering guardianship and control" of the Interstate Commerce Commission, for the purpose of building up, maintaining and safeguarding an adequate national transportation system at all times. The policy has been continued in the Motor Carrier Act of 1935 and in the Transportation Act of 1940. Its wisdom is illustrated in the present emergency. The national defense at the present time is absolutely dependent upon an efficient system of railway operation and it is obvious that in the interest of national defense this transportation system must be maintained at its present capacity for many years to come. If the railroad plant had been accommodated to handle only the traffic which the Commission forecast as the basis of its plans and these reorganizations had proceeded upon that basis, our defense program would have broken down. The railroads would not have been prepared to handle a peak load very much greater than that prevailing through the depression, or that contemplated by the Commission's beliefs as to "capitalizable value."

The public interest in an adequate transportation system rises to a public necessity in time of emergencies. The present war emergency speaks for itself, but there are also the lesser emergencies, such as blizzard, flood, accident or other casualty, which the railroads must likewise stand ready to meet, on even shorter notice. The requirements of the current business of the country in ordinary times are one thing, but an adequate transportation system must be more than adequate to the ordinary occasion. It must stand ready to meet emergency demands. No one can foretell its maximum use.

B.

If a railroad gets into financial difficulty and becomes insolvent or unable to meet its obligations as they mature, it must still serve the public. Its railroad operations must continue even though its fixed charges cannot be met.

In such a situation the public interest may be endangered because pressure to pay fixed charges creates a temptation to reduce service or defer maintenance while impairment of credit tends to make impossible improvement or extension of facilities.

Before 1933 when a railroad fell into financial difficulties its debts might be scaled down by mortgage foreclosure or by equity receivership. These methods were unscientific, often haphazard, slow and costly and frequently did not produce much lasting improvement. At the same time that financial reorganization was being attempted the property was obliged to continue serving the public. Liquidation was not possible. The bankruptcy process did not apply to railroads. Service in the public interest was always paramount.

In 1933, Section 77 was added to the Bankruptcy Act not to permit the liquidation of a railroad or cessation of its service but to enable it to rehabilitate its credit by reducing fixed charges. The purpose of the Act was to relieve debtors (Section 73)—not to relieve them of their properties but of their burdens. Section 77 represents an effort by Congress to facilitate railroad reorganizations by simplifying and reducing the delays and expenses involved in equity receiverships. It provides for an orderly financial reorganization without interfering with railroad operations. Aban-

donment of property or service is still forbidden without permission of the Interstate Commerce Commission.

C.

Though technically included in the Bankruptcy Act, Section 77 is in a larger sense part of Congress' statutory purpose to regulate interstate commerce and particularly to maintain an adequate national transportation system.

In both its procedural and its substantive provisions Section 77 reflects the peculiar obligations attaching to railroad property and operations and the overshadowing requirement of public interest in the maintenance of an adequate national transportation system.

Substantively the purpose and scope of Section 77 is to facilitate the restoration of credit by the reduction of fixed charges of financially distressed railroads in order that they may be able to maintain, operate, improve and expand their properties, so as to perform the service required of them in the public interest.

The Act requires that a plan must be "fair and equitable," must afford "due recognition to the rights of each class of creditors and stockholders," must "not discriminate unfairly in favor of any class of creditors or stockholders," and "will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders," must provide for fixed charges in such an amount that they will be adequately covered by the probable earnings available for their payment (subsections (e) and (b)). There are also certain minor or technical requirements for the plan and certain permissive provisions which need not be enumerated here (subsections (b) and (e)).

Procedurally it "brigades" with the tribunal primarily concerned with financial reorganizations (the Bankruptcy Court), the tribunal to which has been entrusted the maintenance and safeguarding of the national transportation system.

In Part II of this brief we will consider the procedural requirements of Section 77 and in Parts III and IV the substantive requirements.

II. The Interstate Commerce Commission and the Bankruptcy Court are made jointly responsible for the approval of a plan of reorganization under Section 77.

The Interstate Commerce Commission and the Court must each be satisfied that the plan complies with all of the requirements enumerated above (subsections (d) and (e)).

Naturally they cannot both act at the same time. The Interstate Commerce Commission must first approve and the Court must then approve or disapprove the plan certified by the Interstate Commerce Commission. After both have approved, it is submitted to the interested parties for acceptance or rejection before final consummation. Even if it is rejected by the requisite proportion of each class it may nevertheless be consummated if the judge after hearing is again satisfied and finds that it makes adequate provision for fair and equitable treatment of the interests of those who rejected it and that such rejection is not reasonably justified (subsection (e)).

Each tribunal must be independently satisfied that the plan complies with the statutory requirements. The

Commission cannot approve unless "in its opinion" the plan complies with the requirements of subsections (b) and (e) (subsection (d)). The judge cannot approve unless "satisfied" that it complies with those provisions (subsection (e)).

In stating its approval each tribunal must file a written opinion in which it must state the reasons for its conclusions. The Commission shall render a report in which it "shall state fully the reasons for its conclusions" (subsection (d)). The judge "shall file an opinion, stating his conclusions and the reasons therefor" (subsection (e)).

Neither tribunal is permitted merely to describe the evidence and then state its findings or conclusions. Each must also explain the reasoning by which it arrived at its conclusions, *why* it found as it did. Mere enumeration of the factors considered does not satisfy the requirement. The weight accorded to each fact and the reasons why it is considered and why it is given such weight must be set forth.

In this respect Section 77 differs from other statutes covering the relation between courts and administrative tribunals. The court under Section 77 has not merely the ordinary duty of judicial review of an administrative determination. Its responsibility is not limited to seeing that the Commission acted in accordance with the law and had before it some evidence to support its decision. It has an independent responsibility for the fairness of the result. Its duty is just as great as the Commission's to see that the plan is fair and gives due recognition to the rights of all parties. This duty is not fulfilled by a mere determination that the Commission has not acted without evidence or contrary to law.

On the other hand its function and responsibility are not so great as those placed upon the Court of Appeals of the District of Columbia by the Federal Communications Act of 1927, wherein the Court, and not the Radio Commission, had the final word, and might "alter or revise the decision appealed from and enter such judgment as to it may seem just." (See *Federal Commission* v. *Pottsville Broadcasting Co.*, 309 U. S. 134 and cases cited at 144.)

This independent responsibility of the court explains one of Congress' motives for requiring the Commission to state the reasons for its conclusions. If the only duty of the court were to ascertain that there was some evidence to justify the Commission's decision, then the Commission's duty might be discharged by enumerating the facts contained in the evidence and stating its conclusion. That would suffice to permit the court to determine whether there was any possible logical path leading from the facts to the conclusion.

In Section 77 Congress placed a different and greater responsibility on the judge in requiring that he be independently satisfied of the fairness of the plan. It directed him to determine not whether the Commission's conclusion could conceivably follow from the evidence, but whether he as an official charged with responsibility for all sorts of matters relating to financial reorganization agrees with the Commission that the facts justify the conclusion. This duty cannot be properly performed without knowing the reasons why the Commission reached that particular conclusion rather than some other. The judge is not expected to start over from the beginning and work out a conclusion entirely on his own, because his duty is limited to approving or disapproving the plan certified by the Commission. To do that he must know why the Commission approved that particular plan.

Another and equally important motive for requiring statement of reasons by the Commission (and also by the court) is that when a plan is submitted to creditors and stockholders it must be accompanied by both "the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge" (subsection (e)). In order that the security holders may have adequate protection in the determination of their rights they must be given full information as to the reasons for changes, curtailments or eliminations of such rights.

The plan in addition to being "fair and equitable" must afford "due recognition to the rights of each class of creditors and stockholders," must not discriminate unfairly in favor of any of them and must conform to the requirements of the law of the land regarding their participation (subsection (e)). To enable them to know whether it complies with these requirements the Commission and the court must fully explain to them the reasons for the treatment which they receive. The security holders do not have the advantage of seeing and hearing the witnesses testify or studying the exhibits. They receive nothing but the plan itself and the opinions of the Commission and the court.

In a case involving ordinary judicial review of the act of an administrative tribunal Mr. Justice CARDOZO stated that the failure of the Ohio Public Utilities Commission to disclose the evidence upon which its conclusion was supposed to be based constituted a fundamental error resulting in deprivation of property without due process of law. *Ohio Bell Telephone Co.* v. *Commission*, 301 U. S. 292. The reason for that decision was that the plaintiff was deprived of its constitutional right when it was ordered to

refund rates "upon the strength of evidential facts not spread upon the record" (p. 300).*

In a proceeding under Section 77 where the method and mental process by which the Commission traveled from basic facts to final conclusion must be known in order that the courts and the parties may test the fairness of the conclusion, failure to state reasons constitutes an error similar to, and as fatal as that in the *Ohio Bell Telephone Company* case, and if any party is thereby deprived of participation in the reorganization or has the value of his interests reduced, he too is deprived of property without due process of law.

"The rudiments of fair play," to use the phrase which Justice CARDOZO used, depends on what must be made

* Mr. Justice CARDOZO said,

"From the standpoint of due process—the protection of the individual against arbitrary action—a deeper vice is this, that even now we do not know the particular or evidential facts of which the Commission took judicial notice and on which it rested its conclusion. Not only are the facts unknown; there is no way to find them out. When price lists or trade journals or even government reports are put in evidence upon a trial, the party against whom they are offered may see the evidence or hear it and parry its effect. Even if they are copied in the findings without preliminary proof, there is at least an opportunity in connection with a judicial review of the decision to challenge the deductions made from them. The opportunity is excluded here. The Commission, withholding from the record the evidential facts that it has gathered here and there, contents itself with saying that in gathering them it went to journals and tax lists, as if a judge were to tell us, 'I looked at the statistics in the Library of Congress, and they teach me thus and so.' This will never do if hearings and appeals are to be more than empty forms" (pp. 302-3).

"Regulatory commissions have been invested with broad powers within the sphere of duty assigned to them by law. Even in quasi-judicial proceedings their informed and expert judgment exacts and receives a proper deference from courts when it has been reached with due submissions to constitutional restraints. Indeed, much that they do within the realm of administrative discretion is exempt from supervision if those restraints have been obeyed. All the more insistent is the need, when power has been bestowed so freely, that the 'inexorable safeguard' of a fair and open hearing be maintained in its integrity. The right to such a hearing is one of 'the rudiments of fair play' assured to every litigant by the Fourteenth Amendment as a minimal requirement. There can be no compromise on the footing of convenience or expediency, or because of a natural desire to be rid of harassing delay, when that minimal requirement has been neglected or ignored" (pp. 304-5). (Citations omitted.)

known or at least knowable. In so far as present rights to property are to be determined on the basis of its prospective earning power, past and present facts must be translated in the future and forecasts of the future depend upon judgment. Fairness requires that not only the facts but the process by which the judgment is arrived at be made known. When Congress required the Commission to test values by future earning power, it saw that the only way of excluding the possibility of arbitrary action was to require the Commission to state fully the reasons for its conclusions.

This Court has recently held

> "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." *Power Commission* v. *Pipeline Company*, 315 U. S. 575, 586.

The valuation provision in subsection (e) prescribes no formula. As we shall show in a later section of this brief, it is an injunction to the Commission to consider all facts that are "relevant" and to test them in the light of earning power. That leaves a statement of the Commission's reasons as the only way in which its actions can be adequately made known or knowable to the parties whose rights depend on its conclusions. In requiring a statement of reasons Congress was requiring no more than due process of law. A conclusion under Section 77 unaccompanied by the reasons therefor would fall as far short of the minimal requirements of "fair play" as would a finding without disclosure of the evidence on which it was based. The reasoning in the *Ohio Bell Telephone Company* case would apply as fully to the one as to the other.

The district judge is likewise required to state the reasons why he is satisfied with the plan and why he approves it. This he must do for three purposes. The first is for the benefit of the creditors and stockholders to whom the plan is to be submitted. The second is that unless he does so the Circuit Court of Appeals might not be able fully to test the correctness of his decision. The third purpose arises if he disapproves a plan and refers it back to the Commission. Then the Commission must have the benefit of his reasons in order to prepare a new plan.

The decisions of the Circuit Courts of Appeals in both the *Western Pacific* (124 Fed. 2d 136) and the *Chicago, Milwaukee, St. Paul and Pacific* (124 Fed. 2d 754) cases are based upon the failure of the Interstate Commerce Commission and the District Courts to make "findings." Both courts obviously perceived that there was something fundamentally wrong with the records before them, but we submit that they did not state exactly what it was, and their opinions did not reach the core of the difficulty.

The real error lies deeper than the mere lack of "findings." It is the lack of reasons, that is, the failure to explain why they came to their conclusions, which vitiates the action of the Commission and the District Courts.

Section 77 requires that both the Commission and the Court shall be satisfied that the plan "complies" with the requirements of subsection (b), "is" fair, "affords" due recognition, etc. The requirements are all expressed in the present tense. It is not sufficient that the plan "was fair" or appeared to be fair on the basis of some earlier period. Even if the Commission acted in the present tense, its present has become the past and the judge cannot approve the plan unless it still "is" fair at the time of his decision. If circumstances have so changed in the mean-

time that what was formerly fair has now become unfair, the judge cannot be satisfied as required in the statute.

The Act not only permits the judge to hold a hearing, but requires him to do so if any party files objections to the plan as submitted by the Commission (subsection (e)). That he may receive evidence is obvious not only from the provision as to a hearing but from the express requirement that if he disapproves the plan and sends it back to the Commission he shall transmit with it "a copy of any evidence received" (subsection (e)). One of the most important purposes of that hearing is to take account of all the relevant events which have happened since the Commission acted and which the Commission could not have known. Both the Commission and the judge are dealing with the future. Thereby they can be brought nearer to the future.

The courts in Section 77 proceedings act as courts of equity and as such must render their decisions as of the time of the final decree.

This Court said in *Randel* v. *Brown* (2 Howard 406, 423):

> "for it is the rights of the parties, at the time the decree is rendered, that ought to govern the court in rendering the decree."

In *United Corporation* v. *Federal Trade Commission*, 110 Fed. (2d) 473 (C. C. A. 4th Circuit), the court, in an opinion by PARKER, *J.*, set aside an order of the Federal Trade Commission because it had lost jurisdiction of the petitioner during the proceedings. The court referred to the analogy of

> "the rule prevailing in equity to the effect that the court, in making its decree, is governed by the situa-

> tion existing at the time the decree is entered, and not by that which existed at the inception of the litigation" (476).

See also *Stonega Coke and Coal Co.* v. *Price*, 106 Fed. (2d) 411 at 419.

This Court has in several cases held that it was error for a court of equity to confine itself to evidence which had become absolete and misleading at the time of its decree. See *Knoxville* v. *Water Company*, 212 U. S. 1; *A. T. & S. F. Ry. Co.* v. *U. S.*, 284 U. S. 248; *Central Kentucky Co.* v. *Commission*, 290 U. S. 264; *Baltimore & Ohio* v. *U. S.*, 298 U. S. 349; *McCart* v. *Indianapolis Water Company*, 302 U. S. 419.

Knoxville v. *Water Company*, 212 U. S. 1, was an appeal by the City of Knoxville from a decree enjoining certain water rates as confiscatory.

The City ordinance fixing the rates was enacted on March 30, 1901. The suit in equity to restrain the City was brought on December 7, 1901. The decree was entered on January 28, 1905.

Among other objections was the fact that the court considered only the Company's gross income in the fiscal year ending March 31, 1901. Almost four years had passed. As to this this Court said (Mr. Justice Moody) (p. 15):

> "We think it was error to confine the investigation to, and base the judgment upon, that year alone. The precise subject of inquiry was, what would be the effect of the ordinance in the future. The operations of the preceding fiscal year, or of any other past fiscal year, were valueless if the year was abnormal, and were only of significance so far as they foretold the future. If, as in this case, sufficient time has passed, so that certainty instead of prophecy

> can be obtained, the certainty would be preferable to the prophecy. In this case there could be no absolute certainty, because the ordinance had never been put in operation. But evidence of the operations of the years succeeding to the ordinance is relevant and of great importance, and by a consideration of such evidence a much greater degree of certainty could be obtained. Suppose, by way of illustration, that before bringing suit the company had put the ordinance into effect and had observed it for a number of years, and the result showed that a sufficient net income had been realized, is it possible that a suit then could be brought and the evidence confined to a period prior to the ordinance, and by a process of speculation the conclusion reached that the ordinance would be confiscatory? Some evidence regarding the income of the company, after the passage of the ordinance, is in the record, but it subsequently was excluded from consideration. It showed an increase of gross and net earnings, but also an increase in the property devoted to the public use. We are unable to say what the effect of the evidence excluded would be; all we can say is, that the inquiry was unduly limited by the exclusion of the evidence of the operation of subsequent years."

Atchison, etc. Railway Co. v. *U. S.*, 284 U. S. 248 at 260, dealt with an application for an injunction to restrain the enforcement of an Interstate Commerce Commission order prescribing maximum rates. Several applications for a rehearing had been denied by the Commission on the ground of the radically different situation which had supervened since the record before the Commission had been closed in September 1928. The petition

> "asserted that whatever might be the view of the order when made, and upon that record, a changed economic condition demanded reopening and econ-

sideration. The carriers insisted upon this reopening as a right guaranteed to them not only by the Act of Congress but by the Constitution itself" (p. 260).

Chief Justice HUGHES said:

"There can be no question as to the change in conditions upon which the new hearing was asked. Of that change we may take judicial notice. It is the outstanding contemporary fact, dominating thought and action throughout the country. As the Interstate Commerce Commission said in its recent report to the Congress, 'a depression such as the country is now passing through is a new experience to the present generation.' The Commission also recognized in that report 'the very large reductions in railroad earnings which have accompanied the economic depression,' and stated that 'the chief cause of these reductions has been loss of traffic.' For 'in such depressions the railroads suffer severely. Their traffic is a barometer of general business conditions.'

"It is plain that a record which was closed in September, 1928—relating to rates on a major description of the traffic of the carriers in a vast territory—cannot be regarded as representative of the conditions existing in 1931. That record pertains to a different economic era and furnishes no adequate criterion of present requirements. While the effects of the widespread economic disturbance have had a progressive manifestation, they had been sufficiently revealed in February, 1931, when the second petition for rehearing was made, to compel the conclusion that the record of 1928 afforded no sufficient basis for the order of the Commission" (pp. 260-1).

Central Kentucky Co. v. *Commission,* 290 U. S. 264, was an appeal from a decree denying an injunction to re-

strain a gas rate alleged to be confiscatory. The decree of the lower court was entered in September, 1932, but the findings on which it was based made as of December 1926. Meanwhile additional pipeline service, which the franchise required, had been procured by contract with another company. The court below was satisfied that the evidence supported the findings, but directed that the decree of injunction should be entered without adjudicating the validity of the rate so far as it might be affected by the changed conditions and without prejudice to the Commission's fixing a new rate. This Court said (p. 274):

> "As the court considered itself restricted to findings as of December, 1926, it declined to take into account the effect of the increased cost of gas under this contract in making findings as to the propriety of the Commission's rate. That restriction also necessarily excluded from consideration the profound changes in values, costs of service, consumption of commodities and reasonable return on invested capital which we judicially know took place during the period of more than five years while the case was pending before the Commission and the court. See *Atchison, T. & S. F. Ry. Co.* v. *United States*, 284 U. S. 248."

Baltimore & Ohio R. Co., v. *U. S.*, 298 U. S. 349, was a suit in equity to enjoin an order of the Interstate Commerce Commission fixing rates on citrus fruit from Florida. The District Court dismissed the bill and the carriers appealed.

The order which the carriers sought to enjoin prescribed the division of rates on citrus fruit from Florida north over the several carriers. They attacked it on the ground, among others, that it was confiscatory. On this point this Court, after holding that on a constitutional

question the court below must weigh all the evidence and make its own findings, reviewed the carriers' proof of confiscation. In its discussion of the relation of citrus fruit car mile cost to other freight, the Court discussed the test period which had been adopted, which was 1928-29 (374), saying:

> "The test period 1928-29 ended more than one year before the first complaint to the commission, four years before its final decision and the commencement of this suit, five years before entry of the decree appealed from, and six years before submission to this court. In that period there intervened a profound business depression out of which there has been some progress. The evidence fails to show that the relation of citrus fruit car mile cost to the system average has remained the same as appellants claim it was in the test period. Appellants should have brought forward evidence and estimates based on operations subsequent to the complaint, November 22, 1930, and also as near as possible to the time of trial in the district court. The order prescribing the challenged division has been in effect for a long time, and in the absence of proof clearly showing that on the basis of present and prospective conditions it is confiscatory, its enforcement ought not to be enjoined". (pp. 379-380).

The opinion came to the conclusion that:

> "Appellants' failure to introduce evidence based on observations or tests made contemporaneously with transportation, in representative periods subsequent to the taking effect of the order and near to the time of trial, strongly suggests that the figures on which appellants' calculations are based could not be supported and leaves in grave doubt the validity of their proof.
>
> "We conclude that the evidence is not sufficient to establish with requisite certainty what has been

> or will be the cost of the service covered by the prescribed divisions and that the district court rightly dismissed the suit" (381).

There is no necessity here of going as far as the Court went in *McCart* v. *Indianapolis Water Company*, 302 U. S. 419, where it was held erroneous to value the water company's property as of the date of the decree upon proofs taken and concluded thirty-two months previously without regard to known economic changes in the interval. There the economic changes were

> "a constant and definite trend upward in commodity values," (421)

which the judge might be expected to have taken into account and it amounted to no more than 25% on the price index figures (426).

In most of the reorganization proceedings now pending plans were approved by the Commission on the basis of records closed in about 1938. It was contended by many interests that fair reorganizations were not then possible, and that Congress in Section 77(g) did not intend to require immediate reorganization if circumstances were such as to make it impracticable or to create a risk that stockholders or creditors would be subjected to "unnecessary sacrifice."*

The Commission nevertheless approved many plans based on depression earnings and forecasts made in the light of them. By the time some of those plans reached the courts conditions had so changed as to make the Commission's record not only obsolete but seriously misleading. Under the doctrine of the decisions just cited the courts

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* See Report of House Judiciary Committee in 1935 discussed hereinafter in Part III of this brief.

should have found that subsequent events made it impossible for them to be satisfied of the present fairness of the Commission's plans.

The requirement that the court as well as the Commission be satisfied as to the fairness of the plan and the due recognition of the rights of all parties extends to all matters which have a direct bearing on such fairness and recognition. It has been suggested that the last paragraph of subsection (e) places upon the Commission alone the duty of determining values. There is nothing in the paragraph to support this assertion except the requirement that the Commission shall determine and certify value to the court if such determination is necessary. This obviously does not mean that the court must accept without question the Commission's determinations, but merely that the Commission must act first, just as it acts first in approving the plan. Any other meaning would be inconsistent with the requirement that the judge be satisfied as to "fairness" and "due recognition." The fairness of the plan and the due recognition of the rights of all parties could not be determined in any case where values are necessary without consideration of the correctness of the values as certified by the Commission.

It has also been contended that the Commission alone is responsible to see that the plan is "compatible with the public interest" (subsection (d)). This again is based upon the fact that the Commission is expressly required to find that it will be "compatible with the public interest," while there is no similar requirement expressed in connection with the court's approval. It has also been asserted that the Commission must find that the plan "will be" compatible with public interest whereas it is merely required

to find that it "will in its opinion meet with" the other requirements of the Act.

As in the case of the determination of values, we submit that the court is equally responsible with the Commission on all questions of public interest whenever they are of the sort that must necessarily be determind in deciding on the fairness of the plan and the due recognition of the rights of all parties. As this issue has assumed importance in the *Western Pacific* case,* we hope that it may be helpful to the Court to explain our understanding of the phrase "compatible with the public interest."

There are several kinds or fields of public interest. The field in which the Interstate Commerce Commission is primarily concerned is the regulation of interstate commerce and the safeguarding of an adequate national transportation system. Under the Interstate Commerce Act the Commission has extensive powers to require various sorts of things from the carriers in order that the public interest may be served. Without attempting to enumerate all of these matters the thought may be illustrated by referring to the Commission's control over the routing of traffic, the providing of safe facilities, the extension or construction of lines, the abandonment of property or operations, the issuance of securities and leases, mergers and consolidations.

Another large field of public interest is that in which the Bankruptcy Courts are experienced in connection with corporate reorganizations.

To the extent that the field of public interest for which the Interstate Commerce Commission is primarily respon-

* 124 Fed. 2d 136 at 139.

sible overlaps that involved in corporate reorganizations, the court as well as the Commission is competent to determine public interest and equity courts are always charged with the duty of protecting public interest.* Moreover, the scheme of Section 77 requires that the court be satisfied as to the fairness of the plan and the due recognition of the rights of all parties. Therefore, to the extent that matters of public interest lying within the jurisdiction of the Interstate Commerce Commission bear directly upon those questions, the court's duty would not be fulfilled if it did not exercise its own judgment. The illustrative list given above of matters falling primarily within the Interstate Commerce Commission's field of public interest includes one at least which is also within the field of the Bankruptcy Court, and it has a direct bearing on the fairness of a plan of reorganization and the due recognition of the rights of all parties. That one relates to the issuance of securities in so far as it bears upon determination of total capitalization.

We submit, therefore, that in determining total capitalization and values in connection therewith, as in all other matters necessary to determine the fairness of the plan and the due recognition of the rights of all parties, the court has the same responsibility as the Interstate Commerce Commission. Like the Commission it must be satisfied of the correctness of the determination and must set forth the reasons for its conclusions.

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* In *Inland Steel Co.* v. *U. S.*, 306 U. S. 153 at 157, objection was made to a District Court imposing conditions in its decree denying a preliminary injunction against the Interstate Commerce Commission. The Court said,

> "But this overlooks the governing principle that it is the duty of a court of equity granting injunctive relief to do so upon conditions that will protect all—including the public—whose interests the injunction may affect."

III. Section 77 does not require a reduction of capitalization.

A.

The rehabilitation of the credit of a financially distressed railroad requires a reduction in fixed charges but not in total capitalization.

The only express requirement in Section 77 for any change in financial structure is that relating to fixed charges.

Subsection (b)(4) requires that fixed charges be so limited that they shall be adequately covered by probable prospective earnings. This is to avoid recurrence of the danger that earnings which are needed to maintain and develop the property may be diverted to meet fixed charges. There is no similar need for limiting contingent charges or dividends because they do not have to be met unless earnings are sufficient.

In Mr. Eastman's report as Coordinator on January 23, 1935, in which the revised Section 77 was recommended and first drafted, he said (pp. 35-6):

> "It is impossible to support a claim that an extortionate return, or anything approaching such a return, is now being exacted on the money which has gone into the railroads.
>
> "The evil of the railroad debt is quite another matter. The unfortunate part about debt is that the charges which it entails are fixed and must be paid, if insolvency or bankruptcy is to be avoided. Dividends on stock can be suspended without such a result, but not interest on debt. In the railroad world there is intense dread of receiverships or bankruptcies, because of the damage which they do to credit and general confidence among investors to

say nothing of the expense which they have often involved. To avoid such consequences, the property and service may be allowed to deteriorate and unnecessary suffering be imposed on employees through lay-offs or part-time work.

"Such conditions are unhealthy and would not obtain were it not for the disproportionate debt. This debt will also impair the credit of many companies, even when prosperity returns, for only the soundest securities are likely for some time to attract investment, and debt-ridden companies will not have such securities available. They will thus be handicapped in the rehabilitation and modernization of their properties."

There is no requirement for reduction in total capitalization. Such reduction is not necessary to protect against the burden of fixed charges.

The value of the debtor's assets may greatly exceed its liabilities. Insolvency is not necessary to jurisdiction under Section 77. It is sufficient if the court finds that the carrier is "unable to meet its debts as they mature." If insolvency was necessary, the jurisdictional findings would show that assets were insufficient and hence that capitalization was excessive. But mere inability to meet obligations as they mature does not carry any such implication.

The Interstate Commerce Commission has apparently felt that Section 77 constituted a mandate to it to reduce capitalization in all cases where railroads sought reorganization. In spite of occasional protests of reluctance,* it

* "All the Commissioners subscribing to this report and order are deeply sympathetic with an attempt to find some method by which the present stockholders might be lawfully afforded a continuing interest in this property, whether in the way of subscription warrants or a subordinate class of common stock, despite the necessitous condition of the debtor requiring early and drastic reorganization. We reluctantly express the view that this is here impossible, for the law as it stands is inexorably against such a course." *Chicago & N. W. Ry. Co. Reorganization*, 236 I. C. C. 575 at page 637.

seems almost to have welcomed each new reorganization petition as an opportunity to cut down total capitalization.

There is nothing in the statute which requires or even suggests this course. Naturally there was much in the depression psychology of the middle and latter 30's to suggest it to the Commission's mind.

Section 77(b) provides that a plan of reorganization "*shall* include provisions modifying or altering the rights of creditors generally, or of any class of them * * * *may* include provisions modifying or altering the rights of stockholders generally, or of any class of them." (Italics added.)

Mr. Eastman, as Federal Coordinator, in his report of January 20, 1934, the year before the new Section 77 was passed, said,

> "Contrary to much popular impression, the railroads are not in the aggregate overcapitalized, in the sense that the par value of outstanding securities exceeds the money invested in the properties. The Bureau of Valuation of the Interstate Commerce Commission has estimated that the original cost of railroad carrier property, other than land, as it existed on December 31, 1932, plus land valued as of June 1, 1933, and plus allowances for working capital, was in the neighborhood of $26,232,000,000. Original cost of lands is not known, but it was probably materially less than the value as of June 1, 1933. Making all due allowance for this fact, however, the original cost of railroad carrier property would not fall below $24,000,000,000. On December 31, 1932, the total railroad capital actually outstanding was $23,573,556,588, made up of $10,226,070,233 in stock and $13,347,486,355 in funded debt. Allowing for intercorporate holdings, the net capitalization outstanding in the hands of the public was $19,-

489,062,256, made up of $7,150,374,952 in stock and $12,338,687,304 in bonds" (p. 3).

(This was Senate Document No. 119 of the 73rd Congress, 2nd Session.)

In his next report in 1935, which contained the proposed revisions of Section 77, he said,

> "As was pointed out in the First Report of the Coordinator, Senate Document No. 119, the railroads have, in the aggregate, a high percentage of funded debt and a heavy burden of fixed charges. This does not mean that they are in general overcapitalized or that the interest on the debt is an extortionate charge on the public served. Some of the railroads are overcapitalized, but, as was shown in detail in the First Report, the investigations of the Commission have demonstrated that in the aggregate the outstanding capitalization is well below the original cost of the properties and probably, also, below their rate-making value. The latter figure must not, of course, be confused with commercial or market value. Rate-making value is the figure on which the railroads are entitled under the Constitution to earn a fair return if they can; commercial value is the market judgment of what they are worth based on present and prospective earnings, and like all such appraisements is a highly fluctuating amount" (p. 35).

(This was House Document No. 89, 74th Congress, 1st Session.)

The Commission agreed in its 1938 report (in a footnote on page 3 referring to "the relatively large volume of (the railroads') indebtedness"):

> "Certain misunderstandings in regard to this matter merit comment:

"(1) The large amount of railroad debt and fixed charges is not the same thing as 'overcapitalization.' The latter word is often used to describe an excess of capitalization, *i. e.* amount of stock and evidences of indebtedness outstanding, over *cost* of properties, a situation caused ordinarily by the issue of 'watered' stock. The railroads in the aggregate are not overcapitalized in that sense. The word is also used to describe an excess of capitalization over *value* of properties. Using as a measure 'rate-making value,' *i. e.* the amount on which the railroads are entitled as of right under the Constitution to an opportunity to earn a reasonable return, they are not overcapitalized. If commercial value, based upon present earning power, be used as the measure, they are overcapitalized, assuming the apparent estimate of that value in the present stock and bond market to be correct. However, this has not always been so, and such estimates fluctuate continually and rapidly with changing conditions."

Promptness in reorganization is desirable, but in times of violent economic change too much promptness becomes haste. Reorganization is truly prompt when the presentation of the evidence is followed as soon as practicable by the consummation of the plan. True expedition brings these events as near as possible together. Values based on prospective earning power should be brought as close as possible to the consummation of the purpose for which they are made.

What Congress had in mind was made clear when it inserted subsection (g) in the revision of 1935. Hasty reorganizations, which had been possible under Section 77 as originally enacted in 1933, and which had even been encouraged by what was said in the opinion of this Court in *Continental Bank* v. *Rock Island Railway Co.*, 294 U. S.

648 at 685, were to be avoided. That this was the intention of subsection (g) was made clear to the Senate by Senator Wheeler when he presented the Bill and equally clear to the House in the report of the House Committee of the Judiciary reporting the same Bill.

Senator Wheeler said:

> "The present law contemplates hasty reorganizations. The courts have held that, unless there are prompt reorganizations under this statute, the cases must be dismissed, in which event they go back into the old-fashioned equity procedure, from the inefficiences of which it was the purpose of section 77 to escape. The Federal judges are restive, and in a number of cases have issued orders indicating that unless the reorganizations are promptly accomplished, the cases will be thrown back into equity. This puts an unfortunate emphasis upon speed rather than soundness when the act is unworkable. • • •
>
> "Second. As already stated, the present law contemplates hurried procedure. Your committee feels that time ought to be taken to work out these reorganizations with careful consideration. The amended bill carries a provision in paragraph (g), page 28, line 24, which gives the judge discretion as to when he shall dismiss these cases."

(Congressional Record, Vol. 79, p. 13764; Aug. 20, 1935.)

The report of the House Committee, Report #1283, 74th Congress, 1st Session, accompanying H. R. 8587, said:

> "Your committee has considered the protection of stockholders and creditors against unnecessary sacrifice from reorganizations made in a period of depression when bad conditions are transient. In order to protect against hasty reorganizations, and in view of certain dicta in the decision of the Su-

> preme Court in the Rock Island reorganization case above referred to indicating the necessity of prompt action under the present provisions of section 77, H. R. 8587 carries a new subparagraph (g), under which the judge is required to dismiss the proceedings if there is undue delay in a reasonably expeditious reorganization, the matter being left to his sound discretion, after considering the recommendation of the Commission" (p. 3).

Subsection (g) must be read in the light of these two statements. It reads:

> "If in the light of all the existing circumstances there is undue delay in a reasonably expeditious reorganization of the debtor, the judge, in his discretion, shall, on motion of any party in interest or on his own motion, after hearing and after consideration of the recommendation of the Commission, dismiss the proceedings: * * *"

"*Undue* delay" must, of course, be avoided but what is undue must be determined "in the light of all existing circumstances." Promptness and expedition must not become a fetish and the purpose of subsection (g) was to prevent them from becoming a fetish to which the interests of stockholders and creditors, particularly in periods of economic depression and low earnings, might be sacrificed.

The purpose of subsection (g) seems to have been entirely overlooked by the Commission in its zeal to expedite reorganizations and reduce capitalization.

If the Commission uses its power under Section 77 to reduce capitalization at the expense of the stockholders, a statute enacted for the rehabilitation of the debtor becomes an instrument for their liquidation, final and hopeless. Zeal in the interests of under-capitalization would be not

only unfair, it would be short-sighted. The concern of the Commission in the future credit of the road requires a longer view.

B.

A reduction in capitalization without an affirmative finding that existing capitalization is excessive would impair credit, not restore it. Reduction in capitalization would usually mean elimination of stockholders. Such elimination without convincing proof of the lack of value of the assets behind the equity would impair the marketability of railroad stock.

The Commission's 52nd Annual Report, November 1, 1938, is in large part devoted to a consideration of "The Railroad Problem." On pages 9-10, in its discussion of financial reorganizations, the Commission said:

> "It may also be stated with assurance that if railroads are to be operated successfully under private ownership, they must have earnings sufficient to make not only their bonds but also their stock attractive to investors. Otherwise debt will mount until the bonds lose their attraction and the carriers will again be on the road to bankruptcy. The system of private ownership and operation is dependent on the profit motive and will not work well unless, sooner or later, profits are forthcoming."

In the same year, 1938, in its opinion in the *Fifteen Percent Case*, 226 I. C. C. 41, at page 57, the Commission said:

> "*Impairment of credit.* Much of applicant's evidence relates to their impaired financial credit and their consequent inability to finance improvements in their facilities to keep pace with the changing character of the service which they are called upon to furnish. Such improvements are also represented

as necessary to lower the cost of transportation to the shipper as well as to the carrier, and to increase the productivity of the railroad worker. They may be made only if applicants are able to attract adequate supplies of new money at low cost, and sound credit conditions demand that such financing be not merely by the sale of bonds."

In Mr. Eastman's second report as Coordinator, on January 23, 1935, in which he recommended the 1935 amendments to Section 77, he based the protection of the stockholders on the necessity of future credit. In the course of his discussion of railroad financial reorganizations (pp. 35-40), he said:

"The revised statute, if enacted, will furnish a better opportunity and vehicle for railroad financial reorganizations. That, however, is by no means a complete answer to the basic problem. If we are to continue to depend upon private enterprise in the conduct of railroad transportation, profit for the private owners is a *sine qua non*. It is only in the reasonable anticipation of such profit that investors will risk their money in the business. If they are to buy bonds, they must have reasonable assurance that the comparatively low rate of return will be paid in times of depression as well as prosperity; and if they are to buy stock, they must be convinced that if, perchance, dividends are suspended in times of depression, the loss will later be made good by higher than normal dividends. There is no escape from this profit motive under private ownership, for it is the very essence of the system. * * *

"It seems to be a rather common impression that all that is necessary in a reorganization is for the bondholders to accept stock or income bonds, in whole or in part, for their fixed-interest obligations or to scale down interest rates, leaving the present stock unchanged. Manifestly this means a sacrifice

on the part of the bondholders and a surrender of their legal right, all for the benefit of the stockholders and without any corresponding sacrifice on their part. If this is to be the fate of bondholders, it will greatly impair the market for bonds in the future. On the other hand, if railroads are to be reorganized in a manner which will give them a basis for credit under present earnings, the reorganization must in many instances be so drastic that the stockholders will be wiped out. They will be quite unable to pay appropriate assessments, if in fact it is possible for them to pay any. If this is to be the fate of stockholders, it will greatly impair the future market for stock.

"Looking into the future, it is likely that the restoration of railroad credit will proceed slowly, even if there is a steady improvement in net earnings. For a time, only underlying bonds 'next to the rails' will have a market. Then, by degrees, securities with a less favorable position will attract investors, until at length it may prove possible to market new common stock. * * *"

Mr. Eastman's comment that stockholders would have to be "wiped out" if reorganizations were based on "present earnings" must be read in the light of his testimony supporting the bill recommended in the report in which this comment occurs. He said:

"I would like to say, in regard to this use of present and prospective earnings, that a good deal of alarm has been manifested at the use of the word 'present.' Of course, we are not drawing a statute here which is merely applicable to the present moment. We are drawing a statute which we hope will persist for some time to come. At the present moment, it would undoubtedly be unfortunate, unwise, and unfair to put the chief stress or any great stress on present earnings. Prospective earnings are of

more importance for the moment * * *." (Committee Hearings on H. R. 6249 before the Judicial Committee of the House of Representatives, page 287.)

Developing these ideas still further, Mr. Eastman, in June, 1941, said in his dissenting opinion in the St. Louis Southwestern Railway Company reorganization proceeding, 249 I. C. C. 5, at page 191:

> "There are certain other facts which are significant and important. The annual report of the debtor to the Commission for 1940 showed that the system earnings failed to cover fixed charges by $248,758. However, its monthly report of income and balance-sheet items for April 1941 showed that for the first 4 months of this year its income after fixed charges was $1,209,383 as compared with a deficit of $156,052 in the corresponding period last year. If this rate of improvement is maintained throughout the year, as it no doubt will be (it probably will increase), the net income after fixed charges for the year will be an astonishing figure. While I agree that such earnings, produced by the extraordinary conditions created by the national defense program, cannot be regarded as a sound criterion for the future, nevertheless they may well give pause for reflection before a reorganization plan is approved which wipes out all of the existing stock and part of the existing indebtedness. Furthermore, they show that a delay in reorganization now will not involve the constant accumulation of claims for accruing and unearned interest which has been so serious a consequence of delay in the past."

Elimination of junior interests, which usually consist of widely scattered holdings of the small investor, tends to concentrate control of the railroads in the hands of a few large institutional groups dominant or powerful in all these proceedings. Where such control embraces compet-

ing railroads, it is contrary to the policy of the laws protecting competition and of the consolidation provisions of the Interstate Commerce Act.

No class of creditors or stockholders can be eliminated from participation in the reorganization unless its claim is affirmatively found to be valueless. Existence of value, however small, forbids exclusion from participation in the reorganization.

C.

For these reasons we submit that it is not necessary in a reorganization under Section 77 that existing capitalization be reduced. In fact it is not permissible that it be reduced unless there is affirmative proof that the value of the total capitalizable assets is less than the existing capitalization. The burden of proof is on him who says that it should be reduced and that burden cannot be sustained without adequate testimony and a full statement of the reasons as required in the Act.

This brings us to a consideration of the meaning of subsection (e) which deals with the determination of values for any purpose for which values may be made under Section 77.

IV. Subsection (e) provides that in determining value for any purpose under Section 77 the usual elements of value shall be tested in the light of earning power.

In the words of Mr. Justice BRANDEIS (dissenting with HOLMES, *J.* in *Southwestern Bell Tel. Co.* v. *Commission*, 262 U. S. 276, 310), "Value is a word of many meanings." (See also *Guggenheim* v. *Rasquin*, 312 U. S. 254.) Sub-

section (e) of Section 77 deals with the determination of value "for any purpose under this section." The purpose determines the elements which must be emphasized in fixing the value. The weight to be given to each depends upon the kind of value involved.

A.

In a railroad reorganization, where liquidation and distribution of cash or physical assets are out of the question, the problem is to determine the rights of the various parties to participate, and the extent of their participation, in the debtor's estate as a going concern. Total value is not changed by the reorganization, but it must be redistributed among those entitled to share in it. The old elements of value are not discarded, but they must be tested by the future possibilities in the way of earning power.

The last paragraph of subsection (e) provides that value of all property used in railroad operations shall be determined on a basis "which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts" and that only such effect shall be given to reproduction and original cost and the actual investment therein as may be required by the law of the land "in light of its earning power and all other relevant facts." This provision differs from earlier statutory provisions relating to the valuation of railroad property in requiring that "due consideration" be given to earning power and that the usual elements of value be weighed "in the light of" earning power.

The phrase "earning power" is to be distinguished from the word "earnings." In the provision for the coverage of FIXED CHARGES (b)(4), the phrase used is

> "the *probable prospective earnings* of the property in light of its *earnings experience* and all other relevant facts."

The VALUATION clause (e) directs the Commission to give

> "due consideration to the *earning power* of the property, past, present, and prospective, and all other relevant facts."

The use of these two very different phrases, "probable prospective earnings" in one place, "earning power," in the other, was intentional and is of great significance.

The legislative history of this provision shows that as the bill was introduced it required that both earnings and earning power be considered. By amendment before it was enacted the word "earnings" was stricken out.

This begins with Mr. Eastman's draft in his second report as Coordinator, in January 1935. The *first* sentence in his paragraph read:

> "For the purposes of any determination in proceedings under this Section to which the fair valuation of any property used in railroad operation may be necessary, including but not limited by the solvency of the Debtor, such valuation shall be determined on a basis which will give due consideration to the present and prospective net earnings and earning power of the property along with such other facts as may be relevant" (p. 238).

The Committee revised this before the hearings to read:

> "* * * such valuation shall be determined on a basis which will give due consideration to the earning power of the property present and prospective and all other relevant facts" (p. 8).

It will be seen that the Committee struck out the reference to earnings, but left earning power.

In the *second* sentence of the Committee's draft appeared the phrase "in light of its earning capacity and all other relevant facts." During the hearings, the Reconstruction Finance Corporation suggested that the whole of this second sentence be omitted as unnecessary, because the consideration of all relevant facts was required by the first sentence, but that if the second sentence was to be retained, the words "earning capacity" should be changed to read "earning power" to conform to the phrase in the first sentence (Hearings, p. 137). This suggestion was adopted and the second sentence reads, "in light of its earning power and all other relevant facts." In view of this suggestion and the reason upon which it was based, it is clear that the Committee regarded the two phrases as synonymous. "Earning power," therefore, means "earning capacity."*

Not what the Commission may expect the road *will* earn, but what the Commission thinks it *can* earn. That is what Mr. Eastman understood the clause to mean when he testified before the Committee. He said,

> "The question is, what can it earn a return upon; that is the value that we are talking about in considering the solvency or insolvency of a company" (p. 288).

Earnings of railroads usually depend in large measure upon rates. Rates are regulated on the basis of values. If earnings are to be used to fix values, the result is a

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* This is the phrase used by this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510 at 526, "The criterion of earning capacity is the essential one * * *."

vicious circle in which values determine rates and rates determine values (*Southwestern Bell Telephone Co.* v. *Commission*, 262 U. S. 276 at 292, BRANDEIS and HOLMES in dissent; *Commission* v. *Natural Gas Pipe Line Co.*, 315 U. S. 575 at 603, BLACK, DOUGLAS, and MURPHY concurring). Earning power does not involve this vicious circle.

Earning power means the capacity to produce net earnings. It is the product of the physical capacity to handle traffic, the ability to obtain traffic, the ability to convert into net earnings the revenues received therefrom. It does not depend upon the rates currently in effect, although the earnings actually produced at any given time are affected by the rate level. The temporary existence or absence of competitive forms of transportation does not necessarily affect earning power, though it may affect earnings for the time being.

Actual earnings, past, present or prospective, are evidence of earning power, but only when considered in the light of circumstances showing their relation to potential earnings.*

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* In translating earnings into earning power, earnings should be taken before deduction of charges for additions and betterments. The Commission's accounting rule No. 554 requires the deduction from operating income of

> "amounts definitely appropriated from income to be applied for the construction or acquisition of new lines and extensions and of additions to and betterments of property * * *."

This requirement is reflected in past and present earnings as reported by the carriers. Thus net earnings are reduced at the same time that the value and productivity of the property are increased.

Furthermore provisions are being included in the plans of reorganization promulgated by the Commission requiring that a certain sum shall be annually set aside from earnings for the purpose of betterments and additions. It is a prerogative of management to decide how much of earnings ought to be spent in improving the road and how much used for other purposes. If that prerogative is exercised by the Commission, whether through its accounting rules or by so-called Capital Funds in plans of reorganization, it must not be done in a way that will deprive the Debtor of credit for its full earnings.

Whether or not this, that, or another part of the earnings should be spent on betterments is not the question. Of course, the property must be constantly improved. But earnings, past or prospective, which are used as evidence to discover earning power for the purpose of testing capitalization should not be reduced by expenditures which increase the value of the property.

Earning power may be greater than, but cannot be less than, actual current earnings at any given time.* Nor can it be held to be less than the highest actual past earnings without proof that conditions under which such earnings were made have permanently changed in such a way as to put their recurrence out of the question.

In considering values for the purpose of reorganization the property to be taken into account must include all of that which the carrier is required to maintain and operate whether or not it normally shows a profit. Railroads have to operate and maintain much property that does not earn a fair return under normal conditions. Abandonment is not permitted without the authority of the Interstate Commerce Commission. Such authority is not ordinarily granted if there is substantial public demand for continuance of service or unless the particular property sought to be abandoned cannot be operated except at an out-of-pocket loss. Obviously, it would not be fair and equitable, nor would it be permissible under the Constitution, to require the maintenance and operation of such property and yet, on the ground of lack of earnings, exclude from participation in the reorganization those who had invested their money in it. Since the public interest requires its continued operation even without profit, Congress intended its potential rather than its normal earnings to be used to test its value for purposes of reorganization. Any other interpretation of 77 would result in confiscation.

The Commission, we submit, has failed to grasp the true meaning of the statute in respect to earning power. In all the pending reorganizations it has placed chief reliance on past earnings, largely of the depression period,

* It is not necessary in 1942 to determine the exact earning power of the carriers now in reorganization. The measure of capacity represented by current earnings exceeds the amount necessary to justify existing capitalization.

without making any attempt to correlate them with other factors to discover earning power. It uses the terms "prospective earnings" and "earning power" interchangeably. In several cases it has expressed or implied its approval of estimates of what have been denominated "prospective earnings," or prospective net income available for interest. These estimates are not described sufficiently so that their exact character or basis can be discovered, but it is apparent that in no case has the Commission undertaken to determine earning power in the statutory sense.

In every case where the Commission has ventured to prophesy as to prospective earnings, it has been shown by subsequent events to have been wrong, wrong not only in its estimate of probable gross revenues, but also, and even more so, in its lack of faith in the carriers' ability to translate gross into net.

The gross revenues of these railroads, as would naturally be expected, are now running very much higher than at any time during the depression period. They are greatly in excess of the Commission's forecasts.

At the same time, efficiency has increased tremendously, far beyond anything suggested by the Commission. Consequently net earnings are even more seriously out of line with the "prospective earnings" foreseen by the Commission. The success of these carriers, in spite of the large recent increases that have recently occurred in wages, taxes and costs of materials, in improving their operating efficiency, aided by the money that has been put into their properties during their reorganization proceedings, has completely changed the relationship of net to gross as disclosed in the records before the Commission.

For example, in the Chicago, Milwaukee, St. Paul and Pacific plan the Commission accepted with apparent ap-

proval the estimate of the Institutional Group of what it called a "future normal year," fixing $126,900,000 as the probable gross revenues and $15,894,000 as the net available for interest (before taxes). In 1941 the actual gross earnings of the St. Paul were $139,646,000 and the net over $28,939,000. The excess over the "future normal year" was greater in net than in gross. For the first seven months of 1942, the discrepancy in each was even greater.

In the case of the Chicago, Rock Island & Pacific, the Commission estimated that in a normal future year the road would net $11,000,000 out of a gross of $100,000,000. In 1941, with gross about $3,000,000 less than this estimate, the net exceeded the Commission's estimate by about $7,000,000. In 1942 during the first seven months, net was substantially equal to that for the whole of 1941.

These examples might be multiplied from all of the roads as to which the Commission ventured prophecies in 1938 and 1939. There was complete failure to visualize not only the increase in traffic and gross revenues, but even more strikingly the development of the art. Under the spur of motor and other competition, which began during the 20's, and economic depression, which followed in the 30's, the railroads were hard put to it to keep themselves going. Their plants were physically capable of handling a much larger volume of traffic than was left to them and those plants had to be maintained. They were forced to use their utmost ingenuity to develop ways of saving money and getting more net out of gross.

The records before the Commission in these reorganization cases, based on the early and middle 30's, did not, because they then could not, demonstrate the measure of success which these efforts have now attained. They could not inform the Commission how great an increase in effi-

ciency was in the making. They could not show the effect of the millions of dollars which were being put back into the properties.

All this has come to fruition since the close of most of the records before the Commission. The result is greatly improved properties, tremendous increases in cash balances and very much reduced operating ratios. A far greater proportion of gross is now being carried through to net than the Commission thought possible when it approved the several plans, and the current balance sheets show very large increases in investment in road and equipment and in cash. These are accomplished facts which could not be reflected in the plans approved by the Commission.

It has been argued that the present prosperity of the railroads is a mushroom growth and temporary. To what extent this is true is not susceptible of precise determination. To prophesy that the present level of railroad earnings will last only as long as the war lasts is to show lack of understanding of economic history and lack of faith in the development of this country.

There will certainly be a considerable period after the war when railroad traffic will remain at high levels due to the tremendous wastage of the war. The history of past wars bears this out. The brand of Yankee ingenuity which has enabled the railroads, in spite of tremendous increases in taxes, wages and other costs, to show larger ratios of net to gross is not an ephemeral thing. The population of the country is not declining nor, we believe, is there any reason to assume that the standard of living will not continue to follow an upward trend as soon as the exigencies of the war are over. While our competitive forms of transportation are here to stay, they have become increasingly sub-

ject to regulation and the Transportation Act of 1940 shows Congress' purpose that the railroads and all other forms shall be maintained and fostered in the public interest.

For all these reasons we submit that the future of the railroads is now brighter than at any time in the past twenty years and that their earning power cannot be assumed to be declining.

B.

While earning power is to be used to test values based on other "relevant facts," it is not to be made the sole criterion of value.

Section 77(e) requires that "all other relevant facts" be given consideration. It specifically mentions reproduction new and less depreciation, original cost and actual investment.* That they are not intended as an exhaustive list is apparent from the language.

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* They are to be given "only such effect * * * as may be required under the law of the land, in light of its earning power and all other relevant facts." (e)

This language was taken from Paragraph 4, section 15(a) of the Interstate Commerce Act where it is provided:

> "The Commission * * * shall give due consideration to all the elements of value recognized by the law of the land for rate making purposes, and shall give to the property investment account of the carriers only that consideration which under such law it is entitled to in establishing values for rate making purposes."

In Mr. Eastman's opinion this requirement relates to relevancy. In the course of the hearings in 1935, he said:

> "The valuation clause cautions the Commission against the use of estimates of investment or of original or reproduction cost in ascertaining such value, except to the extent that they may be relevant under the law of the land" (p. 287).

And a little later

> "The whole purpose of this valuation clause is to confine the ascertainment of value to legally relevant facts, and to caution the Commission against permitting excursions beyond those facts which would unduly prolong and delay the proceedings" (p. 290).

The facts which have long been considered relevant in determining railroad values include all elements which have a logical and probative bearing. Among others may be mentioned existing capitalization, prudent investment, strategic values (such as the Commission frequently considers in so-called "severance" studies), emergency or stand-by values, market value of non-operating property, salvage value of abandoned property, the values arising out of control of fuel supplies or other necessities or out of ability to control traffic.

Each of these, as well as reproduction and original cost and actual investment, has its bearing, and the relevance and weight to be given to it depend, as indicated above, on the purpose for which the value is to be determined.

For example, when is reproduction cost relevant and what weight should be given to it? Obviously it is relevant when the property in question must continue to be operated. In other words, in every case where if it were accidentally destroyed, public interest would require its reproduction.*

In varying degrees, reproduction cost must always be relevant in the valuation of a concern which is to continue in operation. The degree of its relevancy may depend on the degree of its usefulness and the probability of its being replaced if destroyed. But unless the public interest does not require its continued operation and the Interstate Commerce Commission permits abandonment, reproduction cost cannot be ignored in determining rights to participate in a reorganization.

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* "Thus," Bonbright says, "the value of 1 mile of track on the main line of the Pennsylvania Railroad can safely be assumed to be measured by replacement cost (minus allowances for depreciation and plus allowances for delayed reconstruction); for the absence of this part of the organic whole would cripple the earning power of the entire system. By a similar process of inference, one may conclude with only a slight danger of error that a pair of spectacles or a wooden leg is worth its replacement cost to the owner." (The Valuation of Property, Vol. I, p. 159.)

Actually all railroad property, unless it is to be abandoned, must continually be renewed and improved. While it is not frequently destroyed by accident, it is continually being destroyed in part and replaced in part. Improvements are constantly being made. New property which improves or adds to existing property forms a basis for the issuance of securities. In other words, it adds to capitalizable assets.

Unless it be the two references to earning power in subsection (e) there is nothing in the statute which changes the previously-existing rules for valuing railroad property. All elements of value must be considered in so far as they are relevant. The relevance and the weight to be given to each of them depends, as it always has depended, on the purpose for which the value is to be determined. Earning power is not substituted for the "other relevant facts" but added for the purpose of testing the results which they produce. It is to be given "due consideration" and other elements are to be weighed "in light of" it.

The legislative history of the statute shows that Congress did not intend by subsection (e) to change the law of valuation. Mr. Leslie Craven, author of the 1935 revision under Mr. Eastman's direction, said at the hearings:

> "This valuation provision, as we understand it, is a thoroughly proper statement of the true conception of value as value is in issue in determining the insolvency. We have not changed the conception a bit, do not intend to change it" (p. 320).

Section 77, therefore, does not substitute earning power for the other factors which have always entered into valuations. It requires that they all be considered to the extent that they are relevant to the particular purpose in hand and be given such weight as that purpose entitles them to.

Earning power is emphasized as a measure to test the value so determined.

This avoids the two serious difficulties which would arise if future capitalization were to be determined by capitalizing earning power, *first*, fixing the precise level of earning power and, *second*, deciding what rate of capitalization to employ. Neither of these problems need be faced under what we believe is the correct interpretation of subsection 77(e). All that is necessary is to determine whether earning power is sufficient to show a return on existing capitalization.

Conclusion

We ask the Court to make clear to the Commission and to the Courts the meaning of Section 77, particularly in these three respects: (a) the method of valuation; (b) the duty to take the latest available evidence into account; (c) the necessity of stating the reasons for their conclusions. These are all vital. The lack of authoritative and clear understanding of each of them has contributed to the delays in pending reorganizations. More than that, it has been the chief factor in the confusion which now exists in the sources of private credit on which the transportation system of the country depends. If those sources dry up the inevitable consequence will be public credit, and then public ownership.

An even more important aspect of these cases and reorganization plans is this. They seem to be pervaded by an atmosphere which has never before appeared in this country even in the most difficult of times, an atmosphere of lack of faith in the recuperative powers of the nation and in the ingenuity of private enterprise. Our railroads are now carrying the traffic they were built to carry. They

now have the earnings for which they were capitalized. The Commission now knows this. The Courts know it. But these plans do not show it. Three or four years ago neither the Commission nor the courts would believe it. On the contrary, they convinced themselves that this traffic and these earnings were impossible, that conditions and trends which had obtained prior to the depression would never revive.

While the Commission was facing the future with skepticism, the managements of our railroads were bringing to bear all the skill and ingenuity which they had derived from the difficulties of the last two decades. Through that period they had learned what their future would have to be, what it might be, and how to deal with it. Their faith in the future is strong because they have had to work for it. Railroads are now serving the war emergency needs of this country, partly because they were built and capitalized to meet them, but also because the men who manage them have learned a hard lesson in hard times in the hard way. Railroads now have the business, the earnings, and the earning power. They know how to keep them, and they will not part with them without a struggle.

Sooner or later this faith will be reflected in the Commission. In the meantime every effort should be made to protect honest investments in railroad securities to the end that railroad credit may be restored and faith in the future reflected in plans of reorganization.

Respectfully submitted,

JOHN L. HALL.

JAMES GARFIELD,
CHARLES P. CURTIS, JR.,
Of Counsel.

APPENDIX

Present Status of Reorganization Proceedings of Railroads Here Represented

Chicago, Milwaukee, St. Paul and Pacific Railroad Company

Proceedings commenced on June 29, 1935 under Section 77. Plan certified by the Interstate Commerce Commission to the District Court at Chicago on June 13, 1940. Plan approved by District Court by Decree entered November 13, 1940. Appeals taken by various parties to the Circuit Court of Appeals resulted in a reversal of the Decree of the District Court and a direction to the District Court to set aside its order of approval and to remand the case to the Interstate Commerce Commission.

References: 239 I. C. C. 485
240 I. C. C. 257
36 Fed. Supp. 193
124 Fed. (2d) 754

Chicago and North Western Railway Company

Proceedings commenced on June 28, 1935 under Section 77. Plan certified by the Interstate Commerce Commission to the District Court at Chicago on April 19, 1940. Plan approved by District Court by Decree entered October 12, 1940. Upon the approval of the Plan by the District Court, the Interstate Commerce Commission ordered a submission of the Plan to creditors for acceptance or rejection and the Plan was so submitted on January 25, 1941, resulting in approval by all classes of creditors except one class. The Court subsequently entered an order finding, in effect, that the withholding of the dissenting class was

unwarranted and approved the Plan notwithstanding the disapproval thereof by one class of creditors. Appeals to the Circuit Court of Appeals resulted in an affirmance of the order of the District Court.

References: 236 I. C. C. 575
239 I. C. C. 613
35 Fed. Supp. 230
126 Fed. (2d) 351

Missouri Pacific Railroad Company

Proceedings commenced on March 31, 1933 under Section 77. Plan certified by the Interstate Commerce Commission to the District Court at St. Louis on April 24, 1940. Following the certification of the Plan to the Court and after hearing the Court approved the Plan. The Debtor and other parties in interest appealed from the order of approval to the Circuit Court of Appeals and thereupon applied to the Circuit Court of Appeals for an order staying the submission of the Plan to creditors permitted by the terms of the Plan to participate therein. The Circuit Court of Appeals denied the application for such stay and the Plan was submitted to various classes of creditors and the submission resulted in the approval of the Plan by certain groups and the rejection of the Plan by other groups. Appeals from the order of approval are now pending and set for argument in the forthcoming January Term.

References: 239 I. C. C. 7
240 I. C. C. 15
39 Fed. Supp. 436

Chicago, Rock Island and Pacific Railway Company

Proceedings commenced on June 7, 1933 under Section 77. Plan certified by the Interstate Commerce Commission

to the District Court at Chicago on August 16, 1941. Objections to the Plan have been heard by the District Court but it is understood that the Court has indicated its purpose to reserve decision until after the disposition by the Supreme Court of the cases in which writs of *certiorari* have been granted.

References: 242 I. C. C. 298

St. Louis Southwestern Railway Company

Proceedings commenced on December 7, 1936 under Section 77. Plan certified by the Interstate Commerce Commission to the District Court on March 27, 1942. Objections to the Plan set for hearings before the District Court on June 15, 1942. Upon the request of certain objectors, the hearing has been adjourned until October 24, 1942.

References: 249 I. C. C. 5
252 I. C. C. 325

The Denver and Rio Grande Western Railroad Company

Proceedings commenced on November 1, 1935 under Section 77. Plan certified by the Interstate Commerce Commission to the District Court at Denver, on April 19, 1940. Plan disapproved by the District Court on March 6, 1941, and referred back to the Interstate Commerce Commission. Certain subsequent hearings were held by the Interstate Commerce Commission, and on July 13, 1942, the Interstate Commerce Commission approved a new and different plan based on improved earnings. This Plan is in process of certification to the District Court at Denver.

References: 233 I. C. C. 515
239 I. C. C. 583